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IN THE

# Supreme Court of the United States

October Term, 1942.

No. 341

PACIFIC SOUTHWEST REALTY COMPANY, a corporation,
*Petitioner,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT AND SUPPORTING BRIEF.

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## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT AND SUPPORTING BRIEF.

*To the Honorable Supreme Court of the United States:*

Pacific Southwest Realty Company, a corporation, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit entered in the above cause on June 8, 1942, affirming a decision of the United States Board of Tax Appeals.

### Opinions Below.

The opinion of the United States Board of Tax Appeals [R. 37-65] is reported in 45 B. T. A. 426. The opinion of the Circuit Court of Appeals [R. 213-222] is reported in ..... F. (2d) .....

## Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on June 8, 1942. The jurisdiction of this court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. A. §347).

## Statute Involved.

*Section 23(b) Revenue Act of 1936:*

"In computing net income there shall be allowed as deductions—

(a) * * *

(b) Interest. All interest paid or accrued within the taxable year on indebtedness, * * *"

## Statement of Facts.

The action below is an appeal from a decision of the United States Board of Tax Appeals affirming determinations of respondent of deficiencies in income taxes against petitioner for the years 1936 and 1937.

Petitioner is a Delaware corporation with its principal place of business in the City of Los Angeles, California. [R. 137.] Petitioner was incorporated by persons affiliated with the Pacific Southwest Trust and Savings Bank and First National Bank of Los Angeles for the purpose of acquiring and thereafter owning and operating all the real estate properties owned by the Pacific Southwest Trust and Savings Bank and one parcel of real estate owned by the First National Bank of Los Angeles, and for the further purpose of providing additional bank premises as the growth of the banks required. [R. 137.] The

reason for the organization of petitioner was that the growth of the banks required additional investment in bank premises and in order not to lock up the funds of the bank in real estate used for bank premises it was deemed advisable to organize a subsidiary company to own the real estate and to employ outside capital for that purpose. [R. 137, 159.]

All of the common stock of petitioner was issued to First Securities Company, an affiliate of the above banks. [R. 138.]

During the years 1923, 1924 and 1925 petitioner issued and sold its securities designated 6½% Cumulative Preferred Serial Stock. [R. 138.] During the year 1928 petitioner issued and sold its securities designated 5½% Cumulative Preferred Serial Stock. [R. 140.] Said securities were issued in accordance with and pursuant to the authority granted by article fourth of petitioner's certificate of incorporation. [R. 138, 140.] A true copy of article fourth of the certificate of incorporation is attached to the stipulation of facts as Exhibit "A". [R. 146.] Each of said securities was issued in series. The first series (series A) of the 6½% Cumulative Preferred Serial Stock matured and became payable on July 1, 1929, and the remaining series were to mature and become payable successively on the first day of July of each year thereafter to and including the year 1951. [R. 138.] The first series of the 5½% Cumulative Preferred Serial Stock (series AA) was to mature and become payable on July 1, 1939, and the remaining series were to mature and become payable successively on July first of each year thereafter to and including the year 1960. [R. 140.] The maturity dates of each series of said securities were set

forth in the certificate of incorporation and the maturity date of each security was stated on the face of the certificate issued. [R. 157, 191.]

Said securities provided for the payment to the holders thereof of so-called dividends in the amount of 6½% per annum and 5½% per annum, respectively. The so-called dividends were to be paid out of surplus or net profits prior to the maturity of the securities, but upon maturity or prior liquidation petitioner was required to pay any accumulated unpaid "dividends", as well as the principal sum, out of general assets, if necessary, the same as any claim or debt against the corporation. [R. 153, 187.] The holders of said securities had no right to participate in earnings or profits in addition to the specified fixed "dividends". [R. 157, 192.]

It was provided in the certificate of incorporation and on the face of the certificates issued that upon the maturity date specified each series of said securities "shall be redeemed at par plus unpaid, accrued and accumulated dividends thereon." [R. 153, 187.] It was further provided: "In the event that the corporation shall fail to redeem" any series at the time and place specified "the holders thereof shall have the right to enforce payment of the par value of said stock so agreed to be redeemed, together with the amount of any unpaid, accrued or accumulated dividends thereon, the same as any unconditional claim or debt against the corporation." [R. 153, 187.] It was further provided: "In the event of any liquidation, dissolution or winding up of the corporation, whether voluntary or involuntary," the holders of said securities "shall be entitled, before any distribution shall be made to the holders of the common stock, to be paid out of the surplus

profits arising from the business of this corporation, and then remaining intact, or in case such profits shall be insufficient, then from the general assets of this corporation. an amount equal to the par value thereof plus said fixed redemption premium, plus all unpaid, accrued, or accumulated dividends thereon." [R. 151, 185.]

At the time said securities were issued petitioner had a lease agreement with Pacific Southwest Trust and Savings Bank whereby said bank was obligated to pay as rental a sum which, with the other income of petitioner, would be sufficient to pay all of petitioner's operating expenses, the so-called dividends on petitioner's cumulative preferred serial stock, interest on petitioner's mortgage bonds and the sums necessary to redeem said securities and bonds at maturity. [R. 140, 176.]

The holders of said securities had no voting rights or rights to participate in the management of the corporation except in case of default in payment of the so-called dividends and the continuance of such default for a period of ninety days, in which event the holders of said securities had exclusive voting rights until said default was cured. [R. 154, 188.]

Petitioner's said securities were dealt in, in "over-the-counter" transactions and accrued dividends, prior to actual declaration thereof, were generally taken into consideration in substantially the same manner and to the same extent as accrued interest upon bonds is taken into consideration upon purchase or sale. [R. 39.]

During the year 1936 petitioner made payments of so-called dividends to the holders of its 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock in the amounts of $65,300.63 and $55,000.00,

respectively. [R. 140, 141.] During the year 1937 petitioner made payments of so-called dividends to the holders of its 5½% Cumulative Preferred Serial Stock in the amount of $41,250.00. [R. 141.]

**Additional Facts Pertaining to Discount at Which Securities Were Issued.**

Petitioner's securities designated 5½% Cumulative Preferred Serial Stock were issued and sold at discounts. It is stipulated that

> "If the discount at which said securities were sold was a deductible expense it was an expense which it was proper to amortize and deduct over the life of said securities and $1,833.26 of said discount expense was properly allocable to the year 1936 and $31,275.39 of said discount expense was properly allocable to the year 1937." [R. 141.]

**Additional Facts Pertaining to Premiums Paid on Redemption.**

During the year 1936 petitioner redeemed and retired all of its then outstanding securities designated 6½% Cumulative Preferred Serial Stock for the face value thereof plus a total premium of $182,025.00. [R. 142.]

During the year 1937 petitioner redeemed and retired all of its then outstanding securities designated 5½% Cumulative Preferred Serial Stock for the face value thereof plus a total premium of $20,000.00. [R. 142.]

**Facts Pertaining to Tax Returns, Payment of Tax and Claim for Refund.**

In its income tax return for 1937 petitioner took deductions for the so-called dividends paid to its security holders as interest paid on indebtedness and also took deductions for the discount expense and premiums paid. [R. 144.] In its income tax return for 1936 petitioner did not take deductions for said expenses but claimed the right to deductions for the so-called dividends as interest paid, discount expense and premiums paid in a claim for refund duly filed. [R. 22.] Respondent refused to allow said deductions for either year on the ground that petitioner's securities were preferred stocks. [R. 21.]

Petitioner filed its income tax return for the year 1936 on March 15, 1937, and paid the tax shown thereon in the amount of $83,251.08 in installments as follows: $20,812.77 on March 15, 1937, and like amounts on June 12, September 13 and December 13, 1937. [R. 143.] On March 6, 1940, petitioner duly filed its claim for refund of income taxes overpaid by it for the year 1936 in the amount of $53,900.53. [R. 144.] On May 22, 1940, petitioner paid to the Collector of Internal Revenue for the Sixth District of California the deficiencies in income taxes proposed for the years 1936 and 1937 and herein contested. Said payments were as follows: $842.75 tax, $161.09 interest, or a total payment of $1,003.84 for the year 1936, and $13,878.81 tax, $1,820.21 interest, or a total payment of $15,699.02 for the year 1937. [R. 145.]

## Decisions of Board of Tax Appeals and Circuit Court of Appeals.

The Board of Tax Appeals upheld the action of respondent on the ground that the securities in question were preferred stocks and the Circuit Court of Appeals affirmed the decision of the Board. From the opinions below it is apparent that both the Board and the Circuit Court gave no weight to the terms and conditions of the securities and the obligations imposed upon petitioner but based their decisions entirely upon the names used to describe the securities and the formal manner in which the securities and payments were handled.

## Questions Presented.

1. Whether the terms and conditions of a security or the names used to describe the security and payments thereon are controlling in determining whether a particular security represents indebtedness and whether the payments made to the holders thereof are interest payments on indebtedness within the meaning of Section 23(b) of the Revenue Act of 1936.

2. Whether a security which imposes a definite and legally enforceable obligation upon the issuing corporation to pay the par value thereof and fixed annual percentage payments payable currently out of surplus or net profits but on or before a specified maturity date, regardless of earnings or profits, is a debt and the payments are interest even though the security is named "stock" and the payments are named "dividends".

3. Whether petitioner was indebted to the holders of its securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock and whether the so-called dividends paid to the holders thereof were in fact interest payments on indebtedness.

4. Whether petitioner was entitled to deductions for 1936 and 1937 for a portion of the discount at which its securities designated 5½% Cumulative Preferred Serial Stock were issued and sold.

5. Whether petitioner was entitled to deductions in 1936 and 1937 for the amounts paid as premiums upon the retirement of its securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock.

**Specification of Errors to Be Urged.**

The Circuit Court of Appeals erred:

(1) In basing its determination of the nature of petitioner's securities upon the names used and the manner in which said securities were treated instead of upon the basic terms and conditions of the securities.

(2) In determining that petitioner's securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock did not represent indebtedness of petitioner to the holders of said securities.

(3) In determining that the so-called dividends paid by petitioner to the holders of its securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock were not interest paid

on indebtedness within the meaning of Section 23(b) of the Revenue Act of 1936.

(4) In determining that petitioner was not entitled to deductions for the years 1936 and 1937 for the portions of the discount at which its securities designated 5½% Cumulative Preferred Serial Stock were sold which were allocable to the years 1936 and 1937.

(5) In determining that petitioner was not entitled to deductions for the years 1936 and 1937 for the premiums paid by petitioner during said years upon the redemption of its securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock.

(6) In affirming the decision of the Board of Tax Appeals herein.

**Reasons Relied on for the Allowance of the Writ.**

1. The decision of the Circuit Court of Appeals herein is in conflict in principle with decisions of other Circuit Courts of Appeals.

2. The Circuit Court of Appeals has decided an important question of federal tax law which has not been but should be settled by this Court.